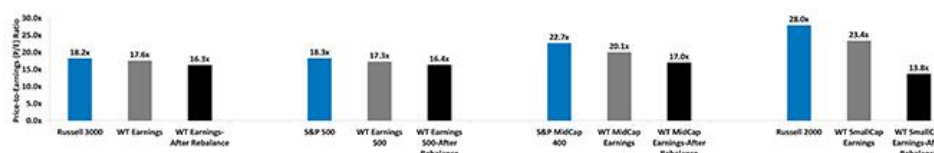


# HOW REBALANCING CAN HELP IMPROVE EARNINGS QUALITY AND LOWER MULTIPLES

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A key process driving the WisdomTree [earnings-weighted](#) Index approach is a [rebalancing process](#) that refreshes constituent weights based on changes in [Earnings Stream®](#) and relative value. In earnings-weighted indexes, changes at the rebalance are made based on each stock's [relative price appreciation](#) compared to its [relative earnings growth](#):

- Companies whose stock prices increased compared to their peers' while their earnings decreased compared to their peers' would typically see reduced weight in the WisdomTree Earnings Indexes. In a [market cap-weighted](#) index, the only driver of weight is the relative change in market capitalization, which is usually driven by the stock price.
- Companies whose stock prices fell while their earnings were flat or grew would typically see increased weight in the WisdomTree Earnings Indexes.
- Companies that have not been profitable on a cumulative basis over the previous four quarters are removed to ensure the continued focus on earnings-generating stocks—one element that improves the quality of the basket by removing more speculative, unprofitable ventures. Weight is also shifted to the relatively more profitable companies and those that have seen highest earnings growth. One way to gauge the impact of the rebalance process is to look at the [price-to-earnings \(P/E\) ratio](#), essentially the price of the Index divided by its [earnings per share](#) before and after the rebalance. Below we show the P/E multiples across market segments. As will be shown, the rebalance can have a large impact on a portfolio's P/E ratio. U.S. Equity Index [Estimated 12-Month P/E Ratios\\*](#) (as of



11/30/14)

Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results.

For

*definitions of terms and indexes in the chart, visit our [glossary](#).*

- **A Lower P/E Ratio Approach:** Even prior to the 2014 rebalance, each earnings-weighted Index exhibited a lower P/E ratio than its market capitalization-weighted counterpart. After the rebalance, the P/E ratios dropped even more significantly compared to these benchmarks. This is a key benefit of the [annual rebalance process](#) that forces the discipline of reweighting to the [fundamental value](#) of the underlying constituents in the Index.
- **Multiples Contracted Anywhere between 7% and 40% across All Indexes:** The [WisdomTree SmallCap Earnings Index](#) saw multiples contract the greatest at approximately 40%. WisdomTree requires each constituent of its earnings family to demonstrate profitability. This addresses the problem seen in the [Russell 2000 Index](#)—namely, a high index-level P/E ratio that is due to index-level earnings being depressed by constituents with negative earnings—by eliminating firms that have had negative earnings over the prior 12 months. Since there are more constituents in small-cap indexes that have delivered negative earnings over the prior 12 months than there are in large-cap indexes, this effect is more pronounced within this size segment.<sup>1</sup> **Rebalance Track**

Record-Consistency in Raising Return on Equity (ROE) Now that we have studied the impact of the rebalance on lowering P/E multiples, we will show the impact of the rebalance in helping to raise the “quality” of the earnings Indexes, measured by the ROE. **Post-Rebalance Raising ROE and Improving Quality**



Sources: WisdomTree, Standard & Poor's, with data from 11/30/14 and 12/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

*For definitions of terms and indexes in the chart, visit our [glossary](#).* This chart illustrates how the rebalance has raised the ROE across four WisdomTree Earnings Indexes. In the 2014 rebalance, for example, the ROE of the WisdomTree SmallCap Earnings Index before and after the rebalance was 7.43% and 11.97%, respectively. As the [bull market](#) in equities carries on, it becomes ever more important to pay attention to the underlying [valuations](#) and market [fundamentals](#). Above we show how the rebalance both lowered the P/E ratios of each WisdomTree Earnings Index and raised the ROE, a key metric of quality. We believe these are attractive attributes of market exposures, made even more important by the continued gains in the market we have seen in recent years. <sup>1</sup>Source: Bloomberg, as of 11/30/14.

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You cannot invest directly in an index.

## DEFINITIONS

**WisdomTree Earnings Index**: Fundamentally-weighted index that measures the performance of earnings-generating companies within the broad U.S. stock market.

**Rebalance**: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**Relative price**: Refers to the share price of the ETF. A large demand for shares, all other things being equal, would be assumed to increase this price.

**Earnings growth estimates**: Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

**Market capitalization-weighting**: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Earnings per share**: Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**Fundamental value**: The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

**WisdomTree SmallCap Earnings Index (WTSEI)**: measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

**Russell 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Bullish**: a position that benefits when asset prices rise.

**Valuation**: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Fundamental value**: The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.